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REFORMING RETIREMENT SAVING TAX INCENTIVES

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REFORMING RETIREMENT SAVING TAX INCENTIVES

ISSUE DEFINITION

The tax treatment of savings in various registered retirement saving plans is a complex issue, but one that is important to Canadians as they save for their retirement. This paper defines the different types of retirement saving, reviews past proposals and examines at length the government's current legislation governing the tax treatment of such saving.

BACKGROUND AND ANALYSIS

A. Types of Retirement Saving Plans

Since the country's elderly population is increasing every year, it is important to establish a retirement saving system that guarantees their financial independence. To achieve this objective, federal and provincial authorities have developed two kinds of saving incentives: the Canada Pension Plan (CPP) and the Quebec Pension Plan (QPP), and a series of tax expenditures favouring certain types of registered saving plans. Such tax measures ought to encourage Canadians to plan for their financial security during retirement by ensuring they will have a guaranteed basic income with no substantial decrease in their standard of living upon retirement. At the end of 1991 (see Table 1), 11,961,360 members had contributed more than $10.8 billion to the Canada and Quebec Pension Plans. That same year, more than 5.3 million persons (or 38.4% of the total work force) contributed nearly $17.1 billion to employer-sponsored pension plans, while 33.4% of the work force contributed over $13.3 billion to registered retirement savings plans (RRSPs).

TABLE 1

COMPARATIVE STATISTICS, 1991

Retirement Program	Number of Contributors	Percentage of Labour Force (%)	Total Contributions ($000)
CPP/QPP	11,961,360	86.5	10,847,000
Employer-sponsored plans	5,318,090	38.4	17,096,000
RRSP	4,617,637	33.4	13,371,000

Source: Statistics Canada.

The substantial sums accumulated show clearly why governments are interested in retirement saving plans and have attempted many times to make them fairer, more efficient and easier to administer. For example, in 1987, for pension plans for employees in activities under federal jurisdiction, the federal government established minimum standards with respect to, among other things, the portability or reimbursement of contributions, early retirement, the vesting of benefits and the locking-in of contributions (*Pension Benefits Standards Act, 1985*). To ensure equitable treatment across the country, all provinces have similar legislation, either in force or awaiting proclamation in full.

Retirement saving plans provide a means of deferring the tax payable on the portion of earnings saved and the interest it collects. Earnings earmarked for retirement are taxed only when received as benefits, not when they are contributed to a plan. At present, the pension plan participant not only sees the real rate of return on his or her savings increase as a result of tax deferment, he or she may pay a lower marginal income tax rate upon retirement.

Employer-sponsored registered pension plans (RPPs) can be one of two types: a defined benefit pension plan or a defined contribution pension plan. In the first case, the plan

member knows the exact value of his or her pension benefits, but not the amount of contributions payable, while in the second case the reverse is true.

Employer and employee RPP contributions to defined contribution plans were limited to a maximum of $3,500 each for 1990 but will increase over time; they will reach $15,500 by 1995 and be indexed to the growth in the average wage thereafter (see Table 3). The amount of benefits paid under defined contribution plans is based on accumulated contributions and investment earnings. With these plans, employees bear the risk of uncertain benefits, since the long-term rate of return determining these benefits is unspecified.

Defined benefit plans guarantee a specific level of pension benefits based on the number of years of service (flat benefit) or on a percentage of earnings (unit benefit) or on both. Specifically, for RPPs registered with Revenue Canada, the benefit limit for the year in which payment of pension benefits starts is not to exceed the lesser of the following two amounts:

a) the defined benefit limit for the year times the number of years of pensionable service; or

b) 2% of the average best three years of earnings times the number of years of pensionable service.

The defined benefit limit is $1,722.22 per year of service, indexed beginning in 1996 as proposed in the February 1992 Budget. There is no fixed maximum limit on employer and employee contributions. Employer contributions are deductible if they equal an amount guaranteeing the promised benefits. In defined benefit RPPs, employers bear the risk, since a fixed level of benefit is guaranteed to the employee according to a projected return.

Deferred profit sharing plans (DPSPs) are defined in section 147 of the *Income Tax Act*. They are financed jointly by the employer and the employee, based on benefit earnings. For 1990, employers could contribute up to $3,500 per employee, less RPP contributions, and reduce their taxable earnings by the same amount. This $3,500 limit will increase to $7,750 by 1995, with increases in the limit related to the growth in the average wage thereafter (see Table 3). Excess employer contributions and employee DPSP contributions are allowed but are not tax-deductible, though returns are, of course, taxed only when received.

Defined in section 146 of the *Income Tax Act*, registered retirement savings plans (RRSPs) are voluntary contribution savings plans, administered individually or jointly. For

1990, the contribution limit for taxpayers who did not participate in an employer-sponsored plan was a maximum of $7,500. This $7,500 maximum will increase to $15,500 by 1996 and will grow in accordance with the change in the average wage thereafter (see Table 3).

In 1992, 8.8% of employer-sponsored registered pension plan members contributed to defined contribution plans and 89.8% to defined benefit plans (see Table 2). The average contribution to an RRSP in 1991 was estimated to be about $2,896.

TABLE 2

PLANS AND MEMBERS
BASED ON THE TYPE OF CONTRIBUTION AND BENEFIT, 1 JANUARY 1992

	Plans		Members	
	Number	%	Number	%
Defined contribution plans	9,901	54.9	469,144	8.8
Defined benefit plans	7,870	43.7	4,775,543	89.8
Other	257	1.4	73,403	1.4
TOTAL	18,028	100.0	5,318,090	100.0

The government felt that over the years there had been a growing inequity in the tax treatment of individuals belonging to different types of retirement saving plans and it found this situation unacceptable. For example, prior to the recent changes, self-employed people and those not contributing to an employer-sponsored plan were limited to RRSP contributions up to a maximum of $7,500. After 35 years of such contributions, there would be an annual pension of $29,000. Employees who participated in a non-contributory plan or a DPSP to which only the employer contributed $3,500 could contribute $3,500 to an RRSP and deduct that amount from taxable income. Thus, up to $7,000 could be put aside in their retirement plan. (However, employees who contributed to an employer-sponsored RPP had to reduce their RRSP contribution by an amount equal to their own contribution to the RPP.) At the end of 35 years, they would have an annual pension of $27,000.

As mentioned earlier, defined benefit plans that are registered with Revenue Canada give a maximum return of the lesser of the defined benefit limit for the year times the number of years of pensionable service or 2% of the average best three years of earnings times years of pensionable service. Prior to the reforms such plans gave much better benefits than plans for employees with defined contribution RPPs or DPSPs, which limited total contributions to an annual ~~$7,000, or than RRSPs for self-employed people, which limited contributions~~ to $7,500. After contributing for 35 years, the defined benefit plan member will have a real annual pension of about $60,278 (i.e., $1,722.22 multiplied by 35 years). Actuarial science has proved that 18% of earnings must be saved to get a pension equal to 2% of these earnings for every year of service. From this 9:1 ratio, it can be said that the $1,722.22 absolute ceiling per year of service approximately equals benefits which would have accumulated with an annual contribution of $15,500. Clearly, prior to recent changes there were disparities strongly in favour of defined benefit RPPs and non-contributory plans. Moreover, if employees were not obliged to contribute to a defined benefit RPP sponsored by the employer, they were able to put a full $3,500 into an RRSP. After 35 years of service, their annual pension would have totalled approximately $73,000. If employer-sponsored RPPs and DPSPs were less generous, however, the tax system did not allow the wage earner to contribute more to an RRSP in order to compensate for lower plan benefits.

Previously, the tax system discouraged self-employment, retroactive contributions to a defined contribution RRSP, DPSP or RPP for past years of service were not allowed, nor was compensation for the loss of benefits when the employee quit his job. Finally, because of a certain laxness in the rules, Revenue Canada had to tolerate some income tax deferrals. With the most recent amendments, the retirement saving system achieved a greater degree of equity in the treatment of individuals belonging to various retirement saving vehicles.

B. Attempts at Reform

In February 1984, Liberal Finance Minister Marc Lalonde announced the first in-depth reform of tax provisions relating to RRSPs since their introduction in 1957. The new

rules called for fairer tax treatment of pension plan members, whether they belonged to defined contribution plans or defined benefit plans. The government also called for the automatic indexing of contribution and pension benefit limits, as well as for greater simplicity and improved flexibility through the introduction of registered pension accounts according to which pensions would be based on a person's total number of years in the work force. The government was forced, however, to drop these proposals because of negative reactions and concern over the administrative complexity of the new rules.

In its 23 May 1985 budget, the new Conservative government reintroduced essentially the same proposals as its predecessor. It called for fairer and more flexible tax assistance for retirement saving, improved equity between individuals with different retirement saving arrangements, greater flexibility in the timing of contributions and increased incentives for employee participation in profit-sharing arrangements.

For individuals participating only in a defined contribution plan, whether employer- or self-administered (for example, DPSPs or RRSPs), it also proposed that the limit on tax-deductible contributions be increased to 18% of earnings to a maximum of $15,500, up from $3,500. With respect to defined benefit plans, the benefit limit would have remained at 2% of the average best three years of earnings, up to a maximum pension of $60,025. It was estimated that after 30 to 35 years in the work force, accumulated benefits would have enabled pensioners to draw a pension equivalent to 60% to 70% of earnings. This amount should have been adequate to meet the needs of retirees and allowed them to maintain their standard of living.

For members of defined benefit plans, the government proposed to limit tax-deductible RRSP contributions to 18% of earnings, up to a maximum of $2,000 per year. The new tax treatment would have enabled those who did not use up their entire RRSP contribution room to carry forward the unused portion of the deduction for seven years. The ceiling on employer contributions to a DPSP would also have been raised to 18% of employee earnings up to a maximum of $7,750 (that is, half of the allowable limit for defined contribution plans). The government did not, however, implement any of these measures.

In his February 1986 budget, the Minister of Finance announced amendments to the *Income Tax Act*. Bill C-23, which was passed in December 1986, instituted two major

changes: contributions to defined benefit plans became fully deductible (since 1985, the tax-deductible portion had been limited to $3,500), and the ceiling on RRSP contributions for individuals not participating in an employer-sponsored pension plan was raised to $7,500 from $5,500 (or, proportionally, to 20% of earnings). It is interesting to note that the allowable limit on tax-deductible RRSP contributions for individuals who were not members of an RPP or a DPSP had not changed in 10 years.

Despite these measures and proposals which were to lead to a fairer tax system, serious inequities persisted. In October 1986, the Minister of Finance announced new legislative measures as a follow-up to the proposals in the May 1985 budget. These measures, which the government claimed were an improvement over the previous ones, had come about as a result of intensive consultations with those directly concerned. For example, the government decided to abandon the 1985 proposal to limit RRSP contributions by defined benefit plan members to $2,000 until a more reasonable option could be found. Since plan return rates were low (less than 2%, for example), defined benefit plan members were at a disadvantage compared to members of more generous plans.

The tabling of the White Paper on Tax Reform in June 1987 temporarily halted the government's plan. In fact, new reform proposals were not introduced until March of 1988.

C. The Current System

On 28 March 1988, the government released draft legislation calling for a fairer and more flexible tax system for dealing with retirement saving. The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants stated the following in a brief to the federal government in May 1988:

> This proposal, which contains perhaps the most complex tax rules ever devised, as well as explanatory notes and a special guide to the legislative provisions, is almost 300 pages in length.

On 19 August 1988, the Minister of Finance announced a one-year postponement in the implementation of the new tax provisions. In so doing, the Minister and his officials felt that the new legislation should take into consideration the constructive comments of experts and

lobby groups. Furthermore, the business community had expressed some hesitation about changing its payroll accounting methods before the new legislation received Royal Assent.

On 27 April 1989, the government announced that the implementation of the new system would be postponed until 1991. This would give employers adequate time to change their payroll systems. The Minister published legislative provisions on 11 December 1989. Bill C-52 contained essentially the same measures first proposed in October 1986, adapted to the need for comprehensive Canadian tax reform.

In 1991, a new limit took effect whereby tax-deductible contributions are not allowed to exceed 18% of earnings. This should ensure that savers are treated more equitably, regardless of the saving plan or plans they have chosen. The new limit should make the tax treatment of defined contribution plans, of RRSPs and of DPSPs the same as that of defined benefit plans. In fact, this 18% ceiling was chosen because it equals the 2% limit per year of service applicable to defined benefit RPPs.

With the 1992 Budget, the phase-in of higher contribution limits for RPPs and RRSPs was delayed, with the hope that the delay would both produce fiscal savings and encourage spending rather than saving as an aid to economic recovery. **The 1995 Budget reduced the dollar limit on deductible RRSP contributions to $13,500 for 1996 and 1997. Beginning in 1998, the limit will increase by $1,000 per year to reach $15,500 in 1999. The dollar limit on contributions to defined contribution RPPs will be similarly reduced to $13,500 for 1996 and will rise by $1,000 a year to reach $15,500 in 1998. The dollar limits on contributions to deferred profit sharing plans will continue to equal one-half the contribution limit for defined contribution RPPs. Reducing the RPP and RRSP limits to $13,500 is expected to have a federal revenue impact of $15 million in 1995-96, $70 million in 1996-97 and $115 million in 1997-98. The Budget also indicated the government's intention to investigate the possibility of modifying RRSP limits to restore lost RRSP room to employees who leave their pension plan prior to retirement; modification would take place without incurring additional revenue costs. Consultations with pension plan sponsors and employee groups on this issue will take place later in 1995.**

As a result of these changes, the effective contribution limit for defined contribution RPPs and for DPSPs will be gradually increased until 1998, and until 1999 in the case of RRSPs (see Table 3). Once the ceilings are fully adjusted, the limit on annual tax-exempt contributions will be $15,500 for RPPs and RRSPs. Indeed, total contributions of $15,500 should give the plan member a pension comparable to the $1,722.22 maximum benefits per year of service he or she could have received had contributions been made to a defined benefit RPP. Beginning in 1991, only employers were allowed to contribute to DPSPs, which explains the lower dollar limit of $7,750. In addition, once the ceilings are reached, the contribution limits will be adjusted yearly on the basis of growth in the average industrial wage. **(This will begin in 1999 for defined contribution RPPs and DPSPs and in the year 2000 for RRSPs.) As far as defined benefit plans are concerned, the allowable maximum benefit limit of $1,722.22 per year of service will be frozen until 1998, after which maximum benefits will rise to one-ninth of the defined contribution ceiling.**

TABLE 3
GRADUAL ADJUSTMENT IN EFFECTIVE LIMITS (DOLLARS)

	Defined Contribution RPP	DPSP	RRSP
1991	12,500	6,250	11,500
1992	12,500	6,250	12,500
1993	13,500	6,750	12,500
1994	14,500	7,250	13,500
1995	15,500	7,750	14,500
1996	**13,500**	**6,750**	**13,500**
1997	**14,500**	**7,250**	**13,500**
1998	**15,500**	**7,750**	**14,500**
1999	**Indexed**	**Indexed**	**15,500**
2000	**Indexed**	**Indexed**	**Indexed**

In order to fix the maximum contribution allowable to an RRSP, a pension adjustment factor is used. In the case of defined contribution plans and DPSPs, the factor is the aggregate of employer, and when appropriate employee, contributions made during the year to

the taxpayer's account. For defined benefit plans, the factor is equal to the amount of benefits accrued during the year, converted into contributions. A factor of 9 is used for this conversion.

In an effort to make the administration of savings plans easier, Revenue Canada, using income tax returns, is calculating the contribution limit for the current year based on the previous year's earnings and contributions and the pension adjustment factors reported by employers on T4 slips; it informs taxpayers of the contribution limit toward the end of each calendar year. The ceiling on RRSP contributions is equal to 18% of the previous year's earnings - up to the maximum effective limit - less the pension adjustment reported for the previous year. For example, deductions allowed for RRSPs in 1993 varied according to 1992 income. This income does not include retirement and pension benefits, retirement allowances, death benefits, RRSP, RRIF and DPSP benefits.

To make tax rules more flexible, the government has introduced the option of a seven-year carry-forward provision for unused portions of RRSP contributions, a measure that will help Canadians with fluctuating incomes to save for retirement.

Should the employer give supplementary benefits for past service (for example, a general raise in benefits), it will have to calculate a past service pension adjustment. This adjustment will reduce contributions allowed under an RRSP. However, the credits for past service will only be certified if the worker used up all past contribution limits to his or her RRSP.

The maximum deduction allowable for a taxpayer's RRSP during one fiscal year is calculated as follows:

$$A + B - C$$

A being unclaimed deductions for RRSPs;

B equalling 18% of earnings made by the taxpayer during the previous year (up to the effective limit) less the aggregate value of the taxpayer's pension adjustments for that year; and

C being the taxpayer's net past service pension adjustment for that same year.

There are also new rules concerning the transfer of funds between registered plans, DPSPs and RRSPs. Thus, lump sums can be transferred tax-free only if this transfer is direct. The transfer of regular periodic amounts (for example, regular payments from CPP, QPP, OAS) is not allowed.

In addition, the legislation contains a number of other amendments affecting in particular the vesting of pension benefits after two years of RPP membership, early or late retirement of an RPP member and multi-employer plans.

D. Impact of Reform on Public Policy

The regulations governing private pension plans are complex, and public debate on the matter is virtually nonexistent. This fact is disturbing, given the importance of the current legislation.

Horizontal equity (defined as the process of giving equal tax treatment to different individuals in identical economic situations) seems assured, as the result of a coherent series of dollar limits applicable to both benefits and contributions. For example, members of defined benefit plans with low investment yields have their eligible RRSP contribution limit increase, individuals with fluctuating incomes are able to carry forward their unused RRSP contribution room for seven years, and the contribution limit for defined contribution plans will henceforth be equal to the value of the annual contributions needed to fund a defined benefit plan.

However, the progressive nature of the new tax system is not readily apparent. On the one hand, increasing the tax-deductible contribution limit favours high-income earners who are defined contribution plan members. Low-income earners experience a drop in their contribution limit in view of the limit on contributions to 18% of earnings. On the other hand, the freeze on dollar limits at $1,722.22 per year of service for benefits guaranteed by defined benefit pension plans, usually benefiting high wage earners, should introduce a certain degree of progressiveness in the tax burden. In addition, members of non-contributory defined benefit plans with a high rate of return have their eligible RRSP contributions decrease substantially.

Under the previous regulations, some taxpayers could defer income tax by having employer contributions made to non-registered plans. For example, some people are members

of defined benefit plans with a benefit rate of more than 2%. Under the new regulations, employers can offer retirement benefits exceeding allowable limits, though without contributions from employer or employees being entitled to income tax deferral. The rules governing retirement compensation arrangements apply, whereby contributions and revenues are subject to a special 50% refundable tax - refunded when benefits are paid out, which will prevent this type ~~of agreement from being used for income tax deferral. Consequently, despite the fact~~ that contributions made under retirement compensation arrangements are deductible, the obligation to pay the refundable tax will prevent people from getting tax relief in this way.

Vesting the pension benefits of DPSP members after two years could prove costly for employers, assuming that this measure will increase staff turnover, and employees could well experience a drop in their salaries in the long term. Conversely, the legislation should result in greater labour mobility, thereby promoting a more efficient economy. However, despite all of the new regulations, many Canadians will still not be able to transfer their contributions from one employer to another unless their pension benefits are vested. And yet, these contributions belong to employees, since they implicitly accepted a lower rate of remuneration in order to earn them.

Administering defined benefit plans is a highly complex process. Employers have their work cut out, in particular in terms of determining past service pension adjustments. Actuarial estimates are very costly. Employers will have to make certain that an employee understands clearly why his or her RRSP contribution limit is being changed and they will have to have large data banks. The Finance Department estimates that compliance costs will total between $60-$70 million in the beginning. For subsequent years, these costs will fall to between $10-$15 million. However, according to Frank Speed, Vice-President of the Canadian Life and Health Insurance Association Inc., "(t)he new tax rules, with their adjustments, will probably create another administrative nightmare and other pension plans will be forced to interrupt their activities." Moreover, in the 1988 Report of the Auditor General of Canada, the one-time cost of the new rules for employers was estimated at $330 million (1988 dollars).

Because of economies made through stricter measures such as the elimination of past service voluntary contributions, transfer restrictions and the end of unlimited wage deferrals under the social benefits plan, the government concludes that the proposed reforms will not cause a net increase of government costs. The reforms should cost the federal government between \$5-\$6 billion annually and between \$8-\$9 billion if the corresponding provincial lost tax revenues are included.

PARLIAMENTARY ACTION

Bill C-52 received Royal Assent on 27 June 1990.

Draft amendments to the Income Tax Regulations relating to retirement saving were released on 31 July 1991 by Finance Minister Don Mazankowski. These regulations complete the implementation of the reform of tax assistance for retirement saving that became law with the Royal Assent of Bill C-52. The regulations include the rules for determining and reporting the pension adjustments for employees who accrue benefits in RPPs and DPSPs. They also include the qualifications for the registration of a pension plan by the Minister of National Revenue. The regulations were promulgated 15 January 1992.

On 26 November 1992 the Minister tabled Bill C-92, which delayed the phase-in of higher contribution and benefit limits for RPPs, DPSPs, and RRSPs (clause 84) and provided the authority to make regulations allowing payments under a Registered Retirement Income Fund (RRIF) to continue throughout the annuitant's lifetime. Bill C-92 received Royal Assent on 10 June 1993.

The February 1995 Budget announced reduced and delayed increases in contribution limits for RRSPs, DPSPs, and RPPs.

The February 1994 Budget had announced that a forthcoming discussion paper would examine the issue of changes to the tax treatment of private retirement saving, including Registered Pension Plans and Registered Retirement Savings Plans, and to the public pension system. **Mention was again made in the February 1995 Budget of this discussion paper, which is expected some time in 1995.**

CHRONOLOGY

1919 -	Employee RPP contributions became tax deductible *(Income War Tax Act)*.
1957 -	RRSPs were introduced as a retirement saving scheme. They were intended primarily for self-employed individuals.
February 1961 -	The *Income Tax Act* was amended to allow employers to contribute to a DPSP.
1966 -	Creation of the CPP and the QPP.
1972 -	Revenue Canada published the first edition of Information Circular 72-13R7, which outlines the regulations governing registered private pension plans.
1976 -	Increase in RPP, RRSP and DPSP contribution limits.
1982 -	Publication of Green Paper entitled *Better Pensions for Canadians*.
1984 -	Publication by the Liberal government of proposals for pension reform. One proposed measure called for the introduction of a funding factor of 9.
May 1985 -	The Conservatives tabled their first pension reform proposals.
February 1986 -	Passage of Bill C-23, amending RRSP contribution limits and eliminating defined benefit plan dollar limits.
October 1986 -	The Minister of Finance announced new legislative provisions which would completely reform private pension plans.
January 1987 -	Coming into force of the *Pension Benefit Standards Act*.
June 1987 -	Publication of the White Paper on Tax Reform.
28 March 1988 -	Tabling of draft legislation to reform the tax treatment of private pension plans.
19 August 1988 -	Consideration of the March 1988 draft legislation was put on hold for one year.
27 April 1989 -	It was announced that the new rules would take effect in 1991.

13 December 1989 - Bill C-52 was tabled in the House of Commons and received first reading.

27 June 1990 - Bill C-52 received Royal Assent.

31 July 1991 - Draft amendments to the Income Tax Regulations relating to retirement saving were released.

15 January 1992 - Amendments to the Income Tax regulations relating to retirement saving were promulgated.

25 February 1992 - The February 1992 Budget announced a delay in the phase-in of higher contribution limits for registered pension plans and registered retirement savings plans, a measure designed to produce fiscal savings and encourage consumer spending.

26 November 1992 - Bill C-92 was tabled; the bill would implement the delay in the phase-in announced in the February 1992 Budget, and would provide the authority to permit payments under RRIFs to continue for the annuitant's lifetime.

10 June 1993 - Bill C-92 received Royal Assent.

22 February 1994 - The February 1994 Budget announced a forthcoming discussion paper that would examine changes to the public pension system and to the tax treatment of private retirement saving.

27 February 1995 - The February 1995 Budget referred to the discussion paper announced in the February 1994 Budget. It indicated that the paper would be released in 1995. The Budget also announced changes to the tax-assisted contribution limits for retirement saving.

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